

An Audit

# **Wisconsin Lottery**

*Department of Revenue*

## **2003-2004 Joint Legislative Audit Committee Members**

### Senate Members:

Carol A. Roessler, Co-chairperson  
Robert Cowles  
Alberta Darling  
Jeffrey Plale  
Julie Lassa

### Assembly Members:

Suzanne Jeskewitz, Co-chairperson  
Samantha Kerkman  
Dean Kaufert  
David Cullen  
Mark Pocan

---

## **LEGISLATIVE AUDIT BUREAU**

The Bureau is a nonpartisan legislative service agency responsible for conducting financial and program evaluation audits of state agencies. The Bureau's purpose is to provide assurance to the Legislature that financial transactions and management decisions are made effectively, efficiently, and in compliance with state law and that state agencies carry out the policies of the Legislature and the Governor. Audit Bureau reports typically contain reviews of financial transactions, analyses of agency performance or public policy issues, conclusions regarding the causes of problems found, and recommendations for improvement.

Reports are submitted to the Joint Legislative Audit Committee and made available to other committees of the Legislature and to the public. The Audit Committee may arrange public hearings on the issues identified in a report and may introduce legislation in response to the audit recommendations. However, the findings, conclusions, and recommendations in the report are those of the Legislative Audit Bureau. For more information, write the Bureau at 22 E. Mifflin Street, Suite 500, Madison, WI 53703, call (608) 266-2818, or send e-mail to [Leg.Audit.Info@legis.state.wi.us](mailto:Leg.Audit.Info@legis.state.wi.us). Electronic copies of current reports are available on line at [www.legis.state.wi.us/lab/windex.htm](http://www.legis.state.wi.us/lab/windex.htm).

---

State Auditor - Janice Mueller

Audit Prepared by

Julie Gordon, Director and Contact Person  
Stephanie Beardsley  
John Brewah  
Brian Geib

# CONTENTS

---

<b>Letter of Transmittal</b>	<b>1</b>
<b>Introduction</b>	<b>3</b>
Ticket Sales	3
Lottery Expenses	4
Statutory Requirements	5
<b>Audit Opinion</b>	<b>7</b>
Independent Auditor's Report on the Financial Statements of the Wisconsin Lottery	
<b>Management's Discussion and Analysis</b>	<b>9</b>
<b>Financial Statements</b>	<b>17</b>
Statement of Net Assets June 30, 2003 and 2002	18
Statement of Revenues, Expenses, and Changes in Fund Net Assets for the Years Ended June 30, 2003 and 2002	19
Statement of Cash Flows for the Years Ended June 30, 2003 and 2002	20
<b>Notes to the Financial Statements</b>	<b>23</b>
<b>Supplementary Information</b>	<b>39</b>
Schedule 1—Reconciliation of Lottery General Operations Expenses to the Budgetary Basis of Accounting—FY 2002-03	40
Schedule 2—Statutorily Defined Lottery Administrative Expenses for the Years Ended June 30, 2001 through 2003	41
Schedule 3—Summary of Prize Expenses for the Years Ended June 30, 1999 through 2003	42
<b>Report on Compliance and Control</b>	<b>43</b>
Independent Auditor's Report on Compliance and on Internal Control over Financial Reporting Based on an Audit of Financial Statements Performed in Accordance with Government Auditing Standards	





State of Wisconsin \ LEGISLATIVE AUDIT BUREAU

JANICE MUELLER  
STATE AUDITOR

22 E. MIFFLIN ST., STE. 500  
MADISON, WISCONSIN 53703  
(608) 266-2818  
FAX (608) 267-0410  
Leg.Audit.Info@legis.state.wi.us

May 27, 2004

Senator Carol A. Roessler and  
Representative Suzanne Jeskewitz, Co-chairpersons  
Joint Legislative Audit Committee  
State Capitol  
Madison, Wisconsin 53702

Dear Senator Roessler and Representative Jeskewitz:

As required by s. 13.94(1)(em), Wis. Stats., we have completed a financial audit of the Wisconsin Lottery, which is administered by the Department of Revenue. We have issued an unqualified opinion on the Wisconsin Lottery's fiscal year (FY) FY 2001-02 and 2002-03 financial statements.

Lottery ticket sales totaled \$435.0 million in FY 2002-03. This level of sales represents an increase of \$7.4 million over FY 2001-02. Property tax relief distributions increased from \$119.0 million in FY 2001-02 to \$129.6 million in FY 2002-03.

We are in the process of completing our biennial program evaluation of the Wisconsin Lottery. We anticipate issuing that report, which will focus on issues concerning contracting and game selection and development, later this summer.

We appreciate the courtesy and cooperation extended to us by the Department of Revenue.

Respectfully submitted,

A handwritten signature in cursive script that reads "Janice Mueller".

Janice Mueller  
State Auditor

JM/JG/ss



## Introduction ■

---

***The Wisconsin Lottery  
sells instant and on-line  
game tickets.***

The Wisconsin Lottery began operations in September 1988, after Wisconsin voters adopted a constitutional amendment in 1987 that allowed the Legislature to create a state lottery and required net proceeds to be distributed for property tax relief. Since August 1995, the Department of Revenue has managed the Wisconsin Lottery, which is permitted to sell tickets for instant and on-line games. Instant games are tickets that reveal a prize when consumers remove scratch-off or pull-tab coverings, while on-line games involve consumers picking numbers from an automated system, with winning numbers selected in drawings held at intervals ranging from daily to twice a week.

We completed a financial audit of the Wisconsin Lottery to fulfill our audit responsibilities under s. 13.94(1)(em), Wis. Stats., and have issued an unqualified opinion on its financial statements for the years ended June 30, 2002 and 2003. As part of our financial audit, we reviewed lottery sales, expenses, and property tax distributions through fiscal year (FY) 2002-03. We also assessed compliance with statutory requirements related to prizes and other costs.

### **Ticket Sales**

***Ticket sales increased  
1.7 percent from  
FY 2001-02 to  
FY 2002-03.***

The Wisconsin Lottery derives over 99 percent of its operating revenues from instant and on-line ticket sales. Total ticket sales increased from \$427.6 million in FY 2001-02 to \$435.0 million in FY 2002-03, as shown in Table 1. The increase of \$7.4 million, or 1.7 percent, is the net result of increased sales of instant game tickets

and slightly decreased sales of on-line game tickets. In February 2004, the Department projected that FY 2003-04 sales would increase 3.0 percent from FY 2002-03 and reach \$448.1 million.

Table 1

**Wisconsin Lottery Sales**  
(In Millions)

Fiscal Year	Instant Games	On-Line Games	Total Sales
2001-02	\$238.2	\$189.4	\$427.6
2002-03	249.4	185.6	435.0

## Lottery Expenses

***Operating expenses increased 2.4 percent from FY 2001-02 to FY 2002-03.***

Wisconsin Lottery operating expenses include prizes paid to winning ticket holders; commissions and incentives paid to ticket retailers; game production costs, such as instant ticket printing and delivery costs and on-line telecommunications charges; product information costs; and other costs, such as staff salaries and fringe benefits. As shown in Table 2, operating expenses increased from \$305.3 million in FY 2001-02 to \$312.7 million in FY 2002-03, or by 2.4 percent. This increase is related primarily to a \$6.9 million increase in prizes paid. An increase in prizes is to be expected with an increase in ticket sales.



Table 2  
**Wisconsin Lottery Operating Expenses**  
(In Millions)

	FY 2001-02	FY 2002-03
Prizes	\$241.6	\$248.5
Retailer Compensation	30.1	30.8
Game Production <sup>1</sup>	19.6	19.2
Product Information	4.5	4.6
Others <sup>2</sup>	9.5	9.6
<b>Total</b>	<b>\$305.3</b>	<b>\$312.7</b>

<sup>1</sup> Includes instant and on-line vendor services, instant ticket printing, on-line telecommunications, and instant ticket delivery expenses.

<sup>2</sup> Includes staff salaries, fringe benefits, supplies, and depreciation expenses.

## Statutory Requirements

### ***The Wisconsin Lottery has complied with statutory limits on lottery expenses.***

State statutes and legislative actions impose limitations on four types of lottery expenses. The Wisconsin Lottery is in compliance with each of the limitations.

- According to s. 25.75(3)(a), Wis. Stats., prizes must equal at least 50 percent of each year's revenues from the sale of lottery tickets. In FY 2002-03, when ticket sales totaled \$435.0 million, prize expenses totaled \$248.5 million, or 57.1 percent of sales.
- According to s. 25.75(3)(b), Wis. Stats., lottery administrative expenses are limited to no more than 10 percent of gross revenues. Administrative expenses, as defined for this purpose, include all expenses except prize expenses and retailer compensation. In FY 2002-03, administrative expenses totaled \$33.5 million, representing 7.7 percent of gross revenues.
- The Wisconsin Constitution prohibits the expenditure of public funds for promotional advertising but permits product informational advertising. Through legislative action, the Wisconsin Lottery's informational advertising

expenses have been limited to \$4.6 million annually. We found this expenditure authority was not exceeded in FY 2002-03.

- State statutes establish maximum compensation rates for basic commissions and incentive-based performance payments to retailers who sell lottery tickets. Basic commission rates are 5.5 percent of the retail price for on-line tickets and 6.25 percent for instant tickets. According to s. 565.02(4)(g), Wis. Stats., the performance payments may provide up to 1.0 percent of total sales as compensation to eligible retailers. In FY 2002-03, incentive-based performance payments totaled \$4.3 million, or 1.0 percent of total sales.

***The Wisconsin Lottery  
provided \$129.6 million  
in property tax relief in  
FY 2002-03.***

As noted, the Wisconsin Constitution requires that net proceeds from the Wisconsin Lottery be used only for property tax relief. Under current law, property tax relief is provided through a credit to owners of primary residences in Wisconsin and through a farmland tax relief credit. In FY 2002-03, lottery proceeds of \$129.6 million were distributed to provide property tax relief. This distribution represented an increase of 8.9 percent from the FY 2001-02 distribution of \$119.0 million.

■ ■ ■ ■

---

# Audit Opinion ■

---

## *Independent Auditor's Report on the Financial Statements of the Wisconsin Lottery*

We have audited the accompanying financial statements of the Wisconsin Lottery as of and for the years ended June 30, 2003 and 2002. These financial statements are the responsibility of the Wisconsin Lottery's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

As discussed in Note 1, the financial statements referred to above present only the Wisconsin Lottery and do not purport to, and do not, present fairly the financial position of the State of Wisconsin and the changes in its financial position and its cash flows, where applicable, in conformity with accounting principles generally accepted in the United States of America.


In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the Wisconsin Lottery as of June 30, 2003, and 2002, and the changes in its financial position and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

As discussed in Note 16 to the financial statements, in fiscal year 2001-02, the Wisconsin Lottery implemented Governmental Accounting Standards Board Statement Number 34, *Basic Financial Statements—and Management’s Discussion and Analysis—for State and Local Governments*.

Our audits were conducted for the purpose of forming an opinion on the financial statements of the Wisconsin Lottery. The supplementary information, including Schedules 1, 2, and 3 and management’s discussion and analysis, is presented for purposes of additional analysis and is not a required part of the financial statements referred to in the first paragraph. The schedules on pages 39 through 42 have been subjected to the auditing procedures applied in the audit of the financial statements and, in our opinion, are fairly stated in all material respects in relation to the financial statements taken as a whole. For management’s discussion and analysis on pages 9 through 16, we have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the supplementary information. However, we did not audit the information and express no opinion on it.

In accordance with *Government Auditing Standards*, we have also issued a report dated May 21, 2004, on our consideration of the Wisconsin Lottery’s internal control over financial reporting and on our tests of its compliance with certain provisions of laws, regulations, and contracts. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* and should be read in conjunction with this report in considering the results of our audit.

May 21, 2004

LEGISLATIVE AUDIT BUREAU  
  
by Julie Gordon  
Audit Director

---

# Management's Discussion and Analysis ■

---

## *Prepared by Wisconsin Lottery Management*

This section of the Wisconsin Lottery's (the Lottery) annual financial report presents management's discussion and analysis of the financial performance of the Lottery during the fiscal year ended June 30, 2003. This discussion should be read in conjunction with the accompanying financial statements and notes. The financial statements, notes, and this discussion are the responsibility of Wisconsin Lottery management.

## **Financial Highlights**

The financial highlights stated below are comparing the financial statements for the fiscal years ended June 30, 2003, and June 30, 2002.

- Operating revenues for lottery activities have increased by \$7.4 million, or 1.7 percent. This increase is the result of instant ticket sales increasing \$11.3 million, or 4.7 percent, while on-line ticket sales decreased \$3.9 million, or 2.1 percent.
- Operating expenses for the year increased \$7.4 million, or 2.4 percent. While some expenses did not change significantly, prize expense increased \$6.9 million, or 2.9 percent, and retailer commissions and incentives increased \$0.7 million, or 2.3 percent.

- Nonoperating revenue, consisting mainly of investment income, increased \$6.1 million, or 132.6 percent.
- Net income before transfers increased \$6.1 million, or 4.8 percent. The increase is a net result of the operating revenue increase, operating expense increase, and the nonoperating revenue increase.

## **Overview of the Financial Statements**

The Lottery is accounted for as an enterprise activity/proprietary fund, reporting on all of the activity's assets and liabilities using the accrual basis of accounting much like a private business entity.

As such, the annual financial report consists of a series of financial statements, along with explanatory notes to the financial statements and supplementary schedules. The Statement of Net Assets is on page 18, the Statement of Revenues, Expenses, and Changes in Fund Net Assets is on page 19, and the Statement of Cash Flows is on page 20.

The Wisconsin Constitution requires net proceeds from the operations of the Lottery to be used to provide local property tax relief. In addition, balances from other gaming-related appropriations, including racing and charitable bingo operations, lapse to the Lottery Fund for distribution in the form of property tax relief. As a result, the net assets of the Lottery consist of capital assets (equipment), restricted income related to unrealized fair market value adjustments to investments, and restricted net assets for property tax relief. To assess the Lottery's financial position and financial health, the reader of these statements should pay particular attention to changes in the components of assets and liabilities as set forth in the Statement of Net Assets. The Statement of Revenues, Expenses, and Change in Fund Net Assets and the Statement of Cash Flows also provide information on income and expenses that should be reviewed as an indicator of the Lottery's financial performance.

## Net Assets

As shown in Table A, the Lottery's total net assets increased \$3.8 million, or 8.1 percent, from FY 2001-02 to FY 2002-03. The total assets decreased \$1.7 million, or 0.9 percent, and the total liabilities decreased by \$5.5 million, or 3.8 percent. The total liabilities decreasing by more than the decrease in total assets caused the increase in total net assets.

Table A

### Net Assets (In Millions)

	FY 2002-03	FY 2001-02	Change	Percentage Change
Investments	\$147.5	\$145.4	\$2.1	1.4%
Capital Assets (Net of Accumulated Depreciation)	0.2	0.2	0.0	0.0
Other Assets	42.9	46.7	(3.8)	(8.1)
<b>Total Assets</b>	<b>190.6</b>	<b>192.3</b>	<b>(1.7)</b>	<b>(0.9)</b>
Current Liabilities	32.3	30.3	2.0	6.6
Noncurrent Liabilities	107.5	115.0	(7.5)	(6.5)
<b>Total Liabilities</b>	<b>139.8</b>	<b>145.3</b>	<b>(5.5)</b>	<b>(3.8)</b>
<b>Net Assets:</b>				
Invested in Capital Assets	0.2	0.2	0.0	0.0
Restricted for Investment Fair Market Value Adjustment	25.3	15.8	9.5	60.1
Restricted for Property Tax Relief	25.3	31.0	(5.7)	(18.4)
<b>Total Net Assets</b>	<b><u>\$50.8</u></b>	<b><u>\$47.0</u></b>	<b><u>\$3.8</u></b>	<b>8.1</b>

The increase in investments by \$2.1 million, or 1.4 percent, is attributable to the \$9.5 million change in market value of investments the Lottery holds to fund future payments due on annuity lottery prizes and to the \$7.4 million decrease due to the redemption of mature bonds. The \$7.5 million decrease in noncurrent liabilities is also the result of annual installment payments from the redemption of mature bonds.

The \$3.8 million decrease in other assets is mainly the result of two accounts decreasing and one account increasing by significant amounts. The cash account decreased by \$5.9 million mainly because the Lottery paid out more in property tax relief in FY 2002-03 than FY 2001-02. The grand prize deposit decreased by \$1.4 million because the Lottery withdrew funds from the unreserved account at the Multi-State Lottery Association (MUSL) to make them available for property tax relief. The accounts receivable increased by \$3.7 million because the large Powerball jackpot the last week of the fiscal year caused increased sales which were not collected until the new fiscal year.

Although the total net assets increased by \$3.8 million, these resources cannot be used for purposes other than restricted purposes. The total net assets consists of \$0.2 million invested in capital assets, \$25.3 million restricted for investment fair market value adjustment, and \$25.3 million restricted for property tax relief. Accounting principles dictate that the gain or loss related to the change in market value of investments be recorded. The investments have been purchased for the payment of installment prize awards and are generally held to maturity. Therefore, the change in the market value of these investments is recorded as a restriction for unrealized gain on investments and is not available for property tax relief.

### **Change in Net Assets**

As shown in Table B, the change in net assets decreased by \$4.9 million, or 56.3 percent. The decrease can be attributed primarily to an increase in total revenues of \$13.5 million, an increase in total expenses of \$7.4 million, and an increase in operating transfer out for property tax relief of \$10.6 million.



Table B  
**Changes in Net Assets**  
(In Millions)

	FY 2002-03	FY 2001-02	Change	Percentage Change
<b>Revenues</b>				
Operating Revenues:				
Ticket sales	\$435.0	\$427.6	\$7.4	1.7%
Retailer fees and miscellaneous revenue	0.1	0.1	0.0	0.0
Nonoperating Revenues:				
Investment income	10.7	4.6	6.1	132.6
<b>Total Revenues</b>	<b>445.8</b>	<b>432.3</b>	<b>13.5</b>	<b>3.1</b>
<b>Expenses</b>				
Program Expenses:				
Prize expense	248.5	241.6	6.9	2.9
Retailer commissions and incentives	30.8	30.1	0.7	2.3
Instant and on-line vendor services	12.5	12.3	0.2	1.6
Other game-related expenses	11.3	11.8	(0.5)	(4.2)
Office Administration Expenses	9.6	9.5	0.1	1.1
<b>Total Expenses</b>	<b>312.7</b>	<b>305.3</b>	<b>7.4</b>	<b>2.4</b>
<b>Net Income Before Transfers</b>	<b>133.1</b>	<b>127.0</b>	<b>6.1</b>	<b>4.8</b>
<b>Operating Transfers</b>				
Transfer for Property Tax Relief	(129.6)	(119.0)	(10.6)	8.9
Transfer In from General Fund	1.2	1.6	(0.4)	(25.0)
Transfer for Compulsive Gambling Programs	(0.3)	(0.3)	0.0	0.0
Transfer for Law Enforcement	(0.3)	(0.3)	0.0	0.0
Transfer for Lottery Credit Administration	(0.2)	(0.2)	0.0	0.0
Transfer Out to General Fund	(0.1)	(0.1)	0.0	0.0
<b>Change in Net Assets</b>	<b><u>\$3.8</u></b>	<b><u>\$8.7</u></b>	<b><u>\$(4.9)</u></b>	<b>(56.3)</b>

The increase in total revenues of \$13.5 million, or 3.1 percent, is the result of ticket sales increasing by \$7.4 million and investment income increasing by \$6.1 million. The ticket sales results by game category are discussed later. The investment income increased by \$6.1 million because the fair market value adjustment to investments was \$6.8 million larger in FY 2002-03 than FY 2001-02, and the state investment pool earnings for the lottery fund decreased \$0.7 million.

The increase in total expenses of \$7.4 million, or 2.4 percent, is mainly the result of prize expense increasing \$6.9 million and retailer commissions and incentives increasing \$0.7 million. In general, prize expense and retailer commissions and incentives are variable expenses, so they increase or decrease in relation to ticket sales. Prize expense results by game category are discussed later. The Lottery's total statutorily defined administrative expenses (instant and on-line vendor services, other game-related expenses, and office administrative expenses) declined from 7.85 percent of gross operating revenues in FY 2001-02 to 7.69 percent of gross operating revenues in FY 2002-03. See Schedule 2 after the notes to the financial statements for more information.

The operating transfer out for property tax relief increased by \$10.6 million, or 8.9 percent. Each year an estimate of total funds available for distribution under the lottery and gaming credit for property taxes is calculated. This calculation analyzes all revenues and expenses of the Lottery with an emphasis on the projected ticket sales and prize expense.

### **Lottery Sales**

Table C compares ticket sales and prize awards for each lottery game category for FY 2002-03 versus FY 2001-02.

Table C  
**Lottery Ticket Sales and Prize Awards**  
(In Millions)

	Ticket Sales			Prize Awards		
	FY 2002-03	FY 2001-02	Change	FY 2002-03	FY 2001-02	Change
<b>Instant</b>						
Scratch	\$245.2	\$233.6	\$11.6	\$155.4	\$147.7	\$7.7
Pull-tab	4.3	4.6	(0.3)	2.7	2.9	(0.2)
<b>On-Line</b>						
Supercash!	28.7	29.5	(0.8)	16.7	15.0	1.7
Powerball	89.1	86.6	2.5	40.8	40.9	(0.1)
WI Very Own Megabucks	22.1	31.2	(9.1)	11.5	16.2	(4.7)
Daily Pick 3	24.6	25.5	(0.9)	11.3	11.7	(0.4)
Daily Pick 4	9.6	9.6	0.0	4.4	4.3	0.1
Badger 5	8.5	0.0	n/a	4.3	0.0	n/a
<b>On-Line (Discontinued Games)</b>						
City Picks	2.9	2.3	0.6	1.4	1.2	0.2
Money Roll	0.0	4.7	n/a	0.0	1.7	n/a
<b>Total</b>	<b><u>\$435.0</u></b>	<b><u>\$427.6</u></b>	<b>\$7.4</b>	<b><u>\$248.5</u></b>	<b><u>\$241.6</u></b>	<b>\$6.9</b>

Instant scratch ticket sales increased by \$11.6 million from FY 2001-02 to FY 2002-03. Although sales of \$1 tickets declined by 13.6 percent, sales of \$2 tickets increased by 9.4 percent, sales of \$3 tickets increased by 20.5 percent, and sales of \$5 tickets increased by 30.7 percent. The Lottery has been strategically focusing on higher price points by increasing payouts of those games and offering a greater number of higher-price-point games. Pull-tab ticket sales decreased by \$0.3 million from FY 2001-02 to FY 2002-03.

In FY 2002-03, the Lottery experienced some significant changes to its on-line game product mix. In February 2003, the Lottery replaced the City Picks game with Badger 5. Badger 5 sales were significantly better than the game it replaced (\$8.5 million total sales). City Picks had replaced Money Roll the previous March. Money Roll was not offered in FY 2002-03. Sales for the Lottery's two jackpot games also fluctuated. Since the Lottery cannot determine when large jackpots will occur, variation in sales for these games is ever present. For example, overall Powerball sales were up due to two large jackpots in December and June.

Wisconsin's Very Own Megabucks sales showed a \$9.1 million decline, since the game did not replicate the record jackpot run of August 2001. All other on-line products performed as expected.

### **Prize Expense**

The increase in prize expense for instant scratch tickets is directly correlated to the increase in sales for that product category. Most of the changes to prize expense for on-line games are also directly related to changes in individual game sales. SuperCash!, however, is an exception. In the summer of 2002, the Lottery made changes to its Money Game Show to allow SuperCash! ticket purchasers the opportunity to appear on the Super Money Game Show. Part of the prize expense for the show was then charged to the SuperCash! game. Prize expense for the SuperCash! game increased even further in the spring of 2003, when game odds were changed to improve the opportunity for SuperCash! ticket purchasers to appear on the show. See Schedule 3 after the notes to the financial statements for a summary of prize expenses.

### **Contacting the Lottery's Financial Management**

This financial report is designed to provide the Legislature and the executive branch of government, the public, and other interested parties with an overview of the financial results of the Lottery's activities and to show the Lottery's accountability for the money it receives. If you have questions about this report or need additional information, contact the Lottery Accounting Section at the Wisconsin Lottery, Post Office Box 8931, Mailstop 6-261, Madison, Wisconsin 53708-8931.

■ ■ ■ ■

---

## **Financial Statements ■**

---

## Statement of Net Assets

### June 30, 2003 and 2002

	June 30, 2003	Restated June 30, 2002
<b>ASSETS</b>		
Current Assets:		
Cash and cash equivalents	\$ 25,429,804	\$ 31,318,251
Investments for prize annuities (Note 4)	16,663,190	16,497,198
Accounts receivable (Note 5)	6,220,237	2,535,318
Due from other state programs (Note 5)	1,936,058	2,238,765
Ticket inventory	1,040,322	849,622
Prepaid expenses	417,950	406,965
Interest receivable	22,934	39,374
Total Current Assets	51,730,495	53,885,493
Noncurrent Assets:		
Investments for prize annuities (Note 4)	130,836,003	128,877,434
Grand prize deposit (Note 8)	7,910,904	9,305,276
Capital assets: (Note 9)		
Equipment	1,118,131	1,287,812
Leasehold improvements	174,102	168,077
Accumulated depreciation	(1,114,471)	(1,219,626)
Total Noncurrent Assets	138,924,669	138,418,973
<b>TOTAL ASSETS</b>	<b>190,655,164</b>	<b>192,304,466</b>
<b>LIABILITIES</b>		
Current Liabilities:		
Annuity prizes payable (Note 6)	16,356,070	16,251,308
Prizes payable	6,300,734	7,159,408
Accounts payable (Note 5)	2,264,752	2,667,825
Due to other state programs (Note 5)	4,393,839	2,948,874
Lottery association payable	1,507,471	440,923
Deferred revenue	1,077,732	368,056
Due to other governments (Note 5)	103,935	199,130
Accrued payroll	184,271	160,913
Compensated absences (Note 14)	127,016	120,878
Total Current Liabilities	32,315,820	30,317,315
Noncurrent Liabilities:		
Annuity prizes payable (Note 6)	107,375,188	114,873,489
Compensated absences (Note 14)	144,242	94,023
Total Noncurrent Liabilities	107,519,430	114,967,512
<b>TOTAL LIABILITIES</b>	<b>139,835,250</b>	<b>145,284,827</b>
<b>NET ASSETS</b>		
Net Assets:		
Invested in capital assets, net of related debt	177,762	236,263
Restricted for investment fair market value adjustment (Note 11)	25,346,610	15,800,334
Restricted for property tax relief (Note 11)	25,295,542	30,983,042
<b>TOTAL NET ASSETS</b>	<b>\$ 50,819,914</b>	<b>\$ 47,019,639</b>

The accompanying notes are an integral part of this statement.

## Statement of Revenues, Expenses, and Changes in Fund Net Assets for the Years Ended June 30, 2003 and 2002

	Year Ended June 30, 2003	Restated Year Ended June 30, 2002
<b>OPERATING REVENUES</b>		
Instant Ticket Sales (net of allowances of \$220,778 and \$158,183, respectively)	\$ 249,467,428	\$ 238,214,016
On-Line Ticket Sales (net of ticket discounts of \$605,091 and \$0, respectively)	185,570,386	189,336,328
Retailer Fees	47,725	52,364
Miscellaneous Revenue	33,962	63,535
<b>Total Operating Revenues</b>	<b>435,119,501</b>	<b>427,666,243</b>
<b>OPERATING EXPENSES</b>		
Program Expenses:		
Instant prize expense	158,065,880	150,658,770
On-line prize expense	90,443,737	90,940,299
Retailer commissions and incentives	30,767,379	30,124,579
Instant and on-line vendor services	12,464,364	12,344,833
Product information costs	4,579,937	4,520,065
Instant ticket printing costs	3,117,049	3,625,080
On-line telecommunication charges	3,093,877	3,090,190
Instant ticket delivery costs	554,808	545,253
Total Program Expenses	303,087,031	295,849,069
Administrative Expenses:		
Salaries and fringe benefits	5,399,940	5,038,051
Supplies and services	4,181,717	4,296,796
Depreciation expense	63,688	114,573
Total Administrative Expenses	9,645,345	9,449,420
<b>Total Operating Expenses</b>	<b>312,732,376</b>	<b>305,298,489</b>
<b>NET OPERATING INCOME</b>	<b>122,387,125</b>	<b>122,367,754</b>
<b>NONOPERATING REVENUES (EXPENSES) AND OPERATING TRANSFERS</b>		
Investment Income (Note 7)	10,671,307	4,618,585
Gain (Loss) on Disposal of Fixed Assets	(37)	(567)
Miscellaneous Revenue	13,235	0
Net Income Before Transfers	133,071,630	126,985,772
Operating Transfers:		
Transfers of Lottery proceeds for property tax relief (Note 12)	(129,564,994)	(118,993,392)
Transfer in from General Fund	1,185,419	1,589,298
Transfer to Department of Health and Family Services for compulsive gambling programs	(250,000)	(250,000)
Transfer to Department of Justice for law enforcement	(292,177)	(283,614)
Transfer to Department of Revenue for lottery credit administration	(250,448)	(192,144)
Transfer out to General Fund (Note 17)	(99,155)	(78,844)
<b>CHANGE IN NET ASSETS</b>	<b>3,800,275</b>	<b>8,777,076</b>
Total Net Assets—Beginning of the Year	47,019,639	38,242,563
Total Net Assets—End of the Year	\$ 50,819,914	\$ 47,019,639

The accompanying notes are an integral part of this statement.

## Statement of Cash Flows for the Years Ended June 30, 2003 and 2002

	Year Ended June 30, 2003	Restated Year Ended June 30, 2002
<b>CASH FLOWS FROM OPERATING ACTIVITIES</b>		
Cash Received from Retailers	\$ 431,629,141	\$ 427,751,918
Cash Paid for Prizes	(263,785,041)	(265,860,693)
Cash Paid/Received for Grand Prize Deposit	1,700,000	1,206,825
Cash Paid to Employees	(5,255,260)	(5,011,970)
Cash Paid to Suppliers	(28,731,489)	(27,951,306)
Cash Paid for Retailer Commissions and Incentives	(31,347,752)	(29,524,829)
<b>Net Cash Provided by Operating Activities</b>	<b>104,209,599</b>	<b>100,609,945</b>
<b>CASH FLOWS FROM NONCAPITAL FINANCING ACTIVITIES</b>		
Transfer of Proceeds for Property Tax Credit	(128,337,485)	(120,703,205)
Transfer of Proceeds from General Fund	1,589,298	2,412,621
Transfer of Proceeds for Law Enforcement	(255,171)	(282,979)
Transfer of Proceeds for Lottery Credit Administration	(242,486)	(191,917)
Transfer of Proceeds for General Fund	(99,155)	(78,844)
Transfer of Proceeds for Compulsive Gambling Programs	(250,000)	(250,000)
<b>Net Cash Used by Noncapital Financing Activities</b>	<b>(127,594,999)</b>	<b>(119,094,324)</b>
<b>CASH FLOWS FROM CAPITAL AND RELATED FINANCING ACTIVITIES</b>		
Cash Paid for Purchase of Equipment	(5,865)	(20,078)
Cash Received from Sale of Equipment	640	0
<b>Net Cash Used by Capital and Related Financing Activities</b>	<b>(5,225)</b>	<b>(20,078)</b>
<b>CASH FLOWS FROM INVESTING ACTIVITIES</b>		
Interest Received	856,422	1,537,228
Cash Received for Redemption of Bonds	16,645,756	20,625,187
Cash Paid for Purchase of Bonds	0	(615,837)
<b>Net Cash Provided by Investing Activities</b>	<b>17,502,178</b>	<b>21,546,578</b>
<b>NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS</b>	<b>(5,888,447)</b>	<b>3,042,121</b>
Cash and Cash Equivalents—Beginning of the Year	31,318,251	28,276,130
Cash and Cash Equivalents—End of the Year	\$ 25,429,804	\$ 31,318,251

The accompanying notes are an integral part of this statement.



	Year Ended June 30, 2003	Restated Year Ended June 30, 2002
<b>RECONCILIATION OF OPERATING INCOME TO NET CASH PROVIDED BY OPERATING ACTIVITIES</b>		
Net Operating Income	\$ 122,387,125	\$ 122,367,754
Adjustments to Reconcile Operating Income to Net Cash		
Provided by Operating Activities:		
Depreciation expense	63,688	114,573
Noncash donated prize expense	13,235	0
Prior-period adjustment	0	300
Changes In Assets and Liabilities:		
Decrease (Increase) in Receivables	(3,684,920)	508,168
Decrease (Increase) in Grand Prize Deposit	1,700,000	1,206,825
Decrease (Increase) in Ticket Inventory	(190,700)	563,745
Decrease (Increase) in Prepaid Expenses	(10,986)	202,518
Decrease (Increase) in Due from Other State Programs	9,681	114,282
Increase (Decrease) in Prizes Payable	(17,496,830)	(23,852,749)
Increase (Decrease) in Deferred Revenue	709,677	80,726
Increase (Decrease) in Due to Other State Programs	58,725	(555,551)
Increase (Decrease) in Accounts Payable	(400,352)	313,829
Increase (Decrease) in Lottery Association Payable	1,066,548	(498,426)
Increase (Decrease) in Due to Other Governments	(95,007)	11,835
Increase (Decrease) in Accrued Payroll	23,358	686
Increase (Decrease) in Compensated Absences	56,357	31,430
Total Adjustments	(18,177,526)	(21,757,809)
<b>Net Cash Provided by Operating Activities</b>	<b>\$ 104,209,599</b>	<b>\$ 100,609,945</b>
Noncash Activities:		
Net change in unrealized gains and losses	\$ 9,525,698	\$ 2,665,376
Noncash donated prize expense	13,235	0

The accompanying notes are an integral part of this statement.



---

# Notes to the Financial Statements ■

---

## 1. DESCRIPTION OF THE WISCONSIN LOTTERY

The Wisconsin Lottery was created in December 1987 and is administered by the Lottery Division within the Department of Revenue. During FY 2002-03, the Wisconsin Lottery administered scratch-off, pull-tab, and on-line games.

The Wisconsin Lottery joined the Multi-State Lottery Association (MUSL) in June 1989. In FY 2002-03, the Wisconsin Lottery, as a member of MUSL, participated in one on-line MUSL game, Powerball (start date April 19, 1992).

During FY 2002-03, the Lottery also sold tickets for six other on-line games: Supercash! (start date February 4, 1991), Wisconsin's Very Own Megabucks (start date June 20, 1992), Daily Pick 3 (start date September 21, 1992), Daily Pick 4 (start date September 15, 1997), City Picks (start date March 26, 2002; end date February 15, 2003) and Badger 5 (start date February 17, 2003).

The Wisconsin Lottery is accounted for within the Lottery Fund, which is part of the State of Wisconsin financial reporting entity. The reporting entity for the Wisconsin Lottery's stand-alone financial statements does not include the appropriations from which the property tax credit disbursements are made. However, disbursements to these appropriations are reported on the Statement of Revenues, Expenses, and Changes in Fund Net Assets as operating transfers out.

## 2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

### A. Fund Accounting and Basis of Presentation

The financial statements of the Wisconsin Lottery have been prepared in conformance with generally accepted accounting principles (GAAP) for proprietary funds. The accompanying financial statements were prepared based upon the flow of economic resources focus and full accrual basis of accounting, with revenues recognized when earned and expenses recognized when incurred.

The Statement of Revenues, Expenses, and Changes in Fund Net Assets classifies the Wisconsin Lottery's fiscal year activity as either operating or nonoperating. Because the Lottery Fund is an enterprise fund, which is a type of proprietary fund, it accounts for operations in a manner similar to private businesses in which operating revenues are derived from exchange transactions, such as sales. Operating expenses include the costs of sales, administration expenses, and depreciation on capital assets.

Certain revenues and expenses that are not related to the Wisconsin Lottery's primary purpose, such as investment income or the gain or loss on the disposal of capital assets, are reported as nonoperating revenues and expenses.

The Wisconsin Lottery applies all Governmental Accounting Standards Board (GASB) pronouncements, as well as the following pronouncements issued on or before November 30, 1989, unless these pronouncements conflict with or contradict GASB pronouncements: Financial Accounting Standards Board (FASB) Statements and Interpretations, Accounting Principles Board Opinions, and Accounting Research Bulletins of the Committee on Accounting Procedure.

The State of Wisconsin monitors expenses and records financial transactions using both the budgetary basis and the accrual basis of accounting. A reconciliation between the budgetary basis and the accrual basis of accounting for general operations expenses is shown in Schedule 1.

### B. Revenue Recognition

Sales of instant scratch-off, instant pull-tab, and on-line tickets are made to the public through licensed retail sales agents.

Instant scratch-off ticket revenues are recognized when tickets are sold to the retailers. Retail sales agents have the right to return unsold instant scratch-off tickets for full refunds. See Note 2(I) for information about accounting for the retailers' right to return scratch-off tickets.

Revenues for pull-tab games are recognized upon sale of the tickets to the retail sales agents. No right of return exists for instant pull-tab tickets.

Ticket revenues for on-line games are recognized at the time the related drawings are held.

**C. Cash and Cash Equivalents**

All cash is deposited with the State of Wisconsin Treasurer and is required to be invested in the State Investment Fund. The State Investment Fund is a short-term pool of state and local funds managed by the State of Wisconsin Investment Board with oversight by its Board of Trustees. Since shares in the State Investment Fund are purchased in \$1,000 increments, Wisconsin Lottery cash balances below \$1,000 are deposited in the State's bank. The State Investment Fund is not registered with the Securities and Exchange Commission as an investment company.

**D. Retailer Commissions**

Retailer commissions, which are classified as program expenses, were 5.5 percent for on-line ticket sales and 6.25 percent for instant scratch and instant pull-tab tickets during FY 2002-03 and FY 2001-02. Nonprofit organizations receive additional commissions.

**E. Retailer Incentive Programs**

In addition to the retailer commissions discussed in Note 2(D), 1999 Wisconsin Act 9 established an incentive program for retailers who meet certain performance goals identified by the Wisconsin Lottery. This program began on January 1, 2000. Retailers must be in good standing and sell scratch-off tickets to participate in the program, which in FY 2002-03 and FY 2001-02 had a winning ticket component, a short-term incentive component, and a sales incentive component. The total compensation provided to all retailers under the components of the program may not exceed 1 percent of the gross revenues from the sale of lottery tickets and lottery shares, which are multi-draw on-line tickets.

Under the winning ticket component, participating retailers that sell a winning scratch-off or on-line game ticket of \$600 or more receive a 2 percent commission of the prize award, up to a maximum of \$100,000 per winning ticket. Winning ticket payments are made weekly.

Up to four short-term incentives a year may be offered for predefined lengths of time. They focus on supporting one product or category of ticket products. Each incentive has a predetermined goal, which lottery retailers must achieve to receive additional compensation. Short-term incentives are limited to a total of \$400,000 per fiscal year, and no more than \$100,000 of funding can be expended on any one short-term incentive.

The sales incentive component allows participating retailers to earn additional commissions based on increased sales realized in any of three product categories: instant tickets, on-line non-jackpot games (Supercash!, Daily Pick 3, Daily Pick 4, City Picks, and Badger 5), and on-line jackpot games (Wisconsin's Very Own Megabucks and Powerball). For the retailer incentive program, the Wisconsin Lottery considers an on-line jackpot game to have a large top prize that may be paid as an annuity or cash option. An on-line non-jackpot prize is smaller and offers only a cash option for payment. Subject to certain restrictions and allowances, retailers earn up to 10 percent of the increase in quarterly sales over sales for the same quarter of the previous year for instant tickets and on-line non-jackpot games, which are paid to them quarterly. Due to the random nature of the on-line jackpot games and the overall program cap, sales incentive program payments for jackpot games are calculated and made annually.

**F. Administrative Expenses**

Administrative expenses are limited to 10 percent of gross lottery revenues. A summary of administrative expenses and related calculations of the administrative expense limit are included in Schedule 2.

**G. Prizes**

In accordance with Wisconsin Statutes, at least 50 percent of lottery sales must be returned in the form of prizes. Prizes may be claimed for a period of 180 days after the drawing for on-line games, or 180 days from the declaration of the end of a game for instant games. A summary of prize expenses is shown in Schedule 3.

**H. Ticket Inventory**

Ticket inventory consists of instant tickets for games in progress that have not yet been sold or shipped, and tickets for new games. The tickets are valued at cost using the first in–first out (FIFO) method. The cost of tickets sold is charged to operations. Unused tickets are charged to operations in the fiscal year the game ends or at the end of ticket distribution for a given game, whichever occurs first.

**I. Deferred Revenue**

Until instant scratch-off tickets are sold to the public, retailers have the right to return unsold tickets to the Wisconsin Lottery for a refund. Therefore, receivables and cash collected in advance of sales of these tickets represent a liability of the Wisconsin Lottery. Deferred revenue is estimated and recorded based on historical information of unsold tickets returned by the retailers.

Depending on the on-line game, on-line tickets are sold for between three and eight subsequent drawings. On-line ticket revenues are recognized at the time the related drawings are held. All ticket sales for future drawings are recorded as deferred revenue.

**J. Capital Assets**

Fixed assets purchased for \$5,000 or more are recorded at historic cost and are depreciated using the straight-line method according to the following schedule:

	<u>Estimated Life</u>
Leasehold Improvements	10 years
Office Furniture and Security Equipment	10 years
Printing and Microfilming Equipment	7 years
Office, Computer, and Data Processing Equipment	5 years
Personal Computers—Acquired after July 1, 1998	4 years

**K. Employee Compensated Absences**

The Wisconsin Lottery's compensated absence liability consists of accumulated unpaid leave, compensatory time, personal holiday hours, and Saturday/legal holiday hours earned and vested as of June 30.

**L. Due to (from) Other State Programs**

During the course of operations, numerous transactions for goods provided or services rendered occur among individual state programs. The Statement of Net Assets classifies these receivables and payables as "Due from other state programs" or "Due to other state programs."

**M. Investment Valuation**

Pool shares of the State Investment Fund are bought and redeemed at \$1.00 based on the amortized cost of the investments in the fund. Income calculations are based on the amortized cost of average pool balances. Where possible, investments in the State Investment Fund are reported at fair value for financial reporting purposes and are based on quoted market prices. Fair value determinations not based on quoted market prices include matrix pricing models or are calculated as the net present value of expected future cash flows. Nonparticipating contracts are valued at cost because these investments do not capture interest rate changes, while other investments are valued at par, which approximates fair value. Fair value of investments for prize annuities is based on quoted market prices.

**N. Disbursement of Lottery Proceeds**

The Wisconsin Lottery disburses lottery proceeds through two means: the Lottery Tax Credit and the Farmland Tax Credit.

The Department of Administration, with the concurrence of the Legislature's Joint Finance Committee, determines the annual amount available for distribution as the Lottery Tax Credit in a given fiscal year. The Department of Revenue is notified of this amount by November 1. The Lottery Tax Credit is paid to municipalities on the 4<sup>th</sup> Monday in March of the same fiscal year.

The Farmland Tax Credit is determined by statute and is distributed to eligible individual and corporate taxpayers through the administration of the Wisconsin Department of Revenue's individual and corporate tax processes. The date of distribution of the Farmland Tax Credit is determined by the dates that eligible claims for it are processed. Therefore, disbursement of Farmland Tax Credit payments occurs throughout the year.

### 3. DEPOSITS

GASB Statement 3 requires deposits with financial institutions to be categorized to indicate the level of credit risk assumed. These risk categories are: 1) insured or collateralized, with securities held by the entity or by its agent in the entity's name; 2) collateralized, with securities held by the financial institution's trust department or agent in the entity's name; and 3) uninsured or uncollateralized. The Lottery had a balance of \$638 in the State's bank on June 30, 2003, and \$945 on June 30, 2002. Both balances met the criteria for risk category 1.

### 4. INVESTMENTS

The Wisconsin Lottery has investments that are held by MUSL, the Wisconsin Lottery, and the State Investment Fund.

Investments have been purchased by the Wisconsin Lottery to finance jackpot prizes that are payable as annuities over the 20-year or 25-year period. These investments for prize annuities are required by MUSL and the Wisconsin Lottery to be in the form of United States zero-coupon treasury securities, securities guaranteed by the United States government, or investment instruments issued by various brokerage firms secured by United States Treasury bonds held by custodial banks. See Note 6 for information related to the annuity prizes payable. The investments are scheduled to mature near the time prize payments become payable to winners. The State's custodial bank held investments for prize annuities with a fair value of \$147,499,193 as of June 30, 2003, and a fair value of \$145,374,632 as of June 30, 2002.

The various types of securities in which the State Investment Fund may invest are enumerated in ss. 25.17(3)(b), (ba), and (bd), Wis. Stats., and include direct obligations of the United States and Canada, securities guaranteed by the United States government, securities of federally chartered corporations, unsecured notes of financial and industrial issuers, Yankee/Eurodollar issues, certificates of deposit issued by banks in the United States and solvent financial institutions in this state, and bankers' acceptances. The State of Wisconsin Investment Board's trustees may approve other prudent investments. The Board of Trustees has given standing authority to the State of Wisconsin Investment Board to invest in resale agreements, financial futures contracts, options, and interest rate swaps. The State Investment Fund is not registered with the Securities and Exchange Commission.



GASB Statement 3 requires investments to be categorized to indicate the level of risk assumed by the Wisconsin Lottery. As of June 30, 2003, all of the assets in investments for prize annuities meet the criteria for risk category 1, because the investments are insured or collateralized and are held by the State or its agent in the State's name. The Wisconsin Lottery's State Investment Fund shares are not categorized.

Cash 4 Life was an on-line game previously offered by the Wisconsin Lottery (start date March 30, 1998; end date September 7, 2000). Investments sufficient to finance the Cash 4 Life prize annuity payments for Wisconsin Lottery Cash 4 Life prizewinners are held by MUSL; therefore, they are not shown as an asset, and the related annuity prizes payable are not shown as a liability on the Wisconsin Lottery financial statements. During FY 2000-01, MUSL sold the securities used to fund the Cash 4 Life lifetime prizes and replaced them with insurance annuities. The insurance company transfers weekly prize payments to the Wisconsin Lottery, which then distributes them to the prizewinners.

## 5. ACCOUNTS RECEIVABLE AND ACCOUNTS PAYABLE BALANCES

Accounts Receivable and Accounts Payable balances, which are combined on the financial statements, are disaggregated as follows:

### A. Accounts Receivable

	<u>FY 2002-03</u>	<u>FY 2001-02</u>
Accounts Receivable:		
Retailers	\$6,216,041	\$2,532,958
Miscellaneous	<u>4,196</u>	<u>2,360</u>
Total Accounts Receivable	<u>\$6,220,237</u>	<u>\$2,535,318</u>
Due from Other State Programs:		
Transfers for Gaming	\$1,185,419	\$1,589,298
Transfers for Farmland Tax Credit	749,844	638,990
Miscellaneous	<u>795</u>	<u>10,477</u>
Total Due from Other State Programs	<u>\$1,936,058</u>	<u>\$2,238,765</u>

**B. Accounts Payable**

	<u>FY 2002-03</u>	<u>FY 2001-02</u>
Accounts Payable:		
Vendors	\$2,112,018	\$2,625,795
Employee Travel Reimbursement	1,162	2,569
Withholding on Prizes	121,230	0
Law Enforcement	63	172
Lottery Credit Administration	2,164	4,867
Retailer Security Deposits	0	2,000
Property Tax	0	5,895
Miscellaneous	<u>28,115</u>	<u>26,527</u>
Total Accounts Payable	<u>\$2,264,752</u>	<u>\$2,667,825</u>
Due to Other State Programs:		
Farmland Tax Credit	\$3,846,515	\$2,514,504
Due to Other State Programs	148,057	299,430
Employee Fringe Benefits	153,560	83,038
Law Enforcement	48,491	8,214
Lottery Credit Administration	27,126	19,524
Withholding on Prizes	163,740	24,164
Property Tax	<u>6,350</u>	<u>0</u>
Total Due to Other State Programs	<u>\$4,393,839</u>	<u>\$2,948,874</u>
Due to Other Governments:		
Employee Fringe Benefits	\$ 42,844	\$ 41,623
Withholding on Prizes	57,771	153,999
Law Enforcement	1,669	2,003
Lottery Credit Administration	<u>1,651</u>	<u>1,505</u>
Total Due to Other Governments	<u>\$103,935</u>	<u>\$199,130</u>

**6. ANNUITY PRIZES PAYABLE**

The Wisconsin Lottery has an unconditional obligation to pay all prize winners the future value of the prize. The reported value of future jackpot prize payment obligations is included in the financial statements as "Annuity prizes payable." To finance the annuity prize payments, the Wisconsin Lottery purchases, or has acquired from MUSL, investments scheduled to mature near the time prize payments become payable to the winners. Each year, an adjustment to the annuity prizes payable account is made to amortize the reported value using the effective interest method. The present value adjustment was \$9,244,618 for FY 2002-03 and \$9,819,227 for FY 2001-02. See Note 4 for information related to the investments for prize annuities.

The reported values of future prize payment obligations were as follows:

<u>Fiscal Year</u>	<u>FY 2002-03 Total Payments</u>	<u>FY 2001-02 Total Payments</u>
2002-03	—	\$ 16,634,820
2003-04	\$ 16,749,915	16,749,915
2004-05	16,867,731	16,867,731
2005-06	16,991,521	16,991,521
2006-07	17,118,314	17,118,314
2007-08	17,250,339	17,250,339
Subsequent Years	<u>101,817,722</u>	<u>101,817,722</u>
Future Prize Payments	186,795,542	203,430,362
Less: Present Value Adjustment	<u>63,064,283</u>	<u>72,305,565</u>
Present Value of Future Prize Payments	<u>\$123,731,259</u>	<u>\$131,124,797</u>

Annuity prizes payable activity for the fiscal years ended June 30, 2003, and June 30, 2002, was as follows:

<u>Fiscal Year</u>	<u>Beginning Balance</u>	<u>Increases</u>	<u>Decreases</u>	<u>Ending Balance</u>	<u>Due within One Year</u>
2002-03	\$131,124,797	\$ 9,244,618	\$(16,638,156)	\$123,731,259	\$16,356,070
2001-02	141,307,592	10,435,063	(20,617,858)	131,124,797	16,251,308

## 7. INVESTMENT INCOME

The investment income shown on the financial statements consists of several elements, as shown below:

	<u>FY 2002-03</u>	<u>FY 2001-02</u>
Interest from State Investment Fund	\$ 814,523	\$1,477,576
Net Increase in Fair Value of Annuity Investments	18,770,316	12,484,602
Decrease for Amortization of Annuity Investments	(9,244,618)	(9,819,227)
Net Change in Fair Value of State Investment Fund	20,579	5,291
Interest from MUSL Prize Reserve Accounts	305,627	461,083
Miscellaneous Interest	<u>4,880</u>	<u>9,260</u>
Total Investment Income	<u>\$10,671,307</u>	<u>\$4,618,585</u>

The Wisconsin Lottery earns interest on its shares invested in the State Investment Fund and on its share of the grand prize deposit fund established through MUSL, which is discussed in Note 8. Under GASB Statement 31, which requires investments to be reported at fair value, the net increases or decreases in fair value of investments for prize annuities and shares in the State Investment Fund are recognized as investment income (loss). Investments for prize annuities are amortized with a corresponding amortization adjustment to annuity prizes payable. The amortization of annuity prizes payable is included as a reduction to investment income.

## 8. GRAND PRIZE DEPOSIT

A grand prize deposit fund has been established by MUSL to indemnify states participating in the Powerball and Cash 4 Life games should a winning ticket not be properly paid. The combined Powerball and Cash 4 Life grand prize deposit for the State of Wisconsin was \$7,910,904 at June 30, 2003, and \$9,305,276 at June 30, 2002.

### A. Powerball

The total prize pool equals 50 percent of sales for each Powerball drawing. Of the total prize pool, 58.39 percent funds the grand prize pool, and 41.61 percent funds the low-tier prize pool. After the grand prize pool reaches the annuitized amount of \$5 million, 2 percent of draw sales is distributed to the Prize Reserve Account (PRA) and Set Prize Reserve Account (SPRA) until they reach their caps of \$52 million and \$30 million, respectively. Interest earned on these accounts is deposited to the Unreserved Account. For some draws, the PRA and SPRA are reduced when the actual prizes won are greater than the amounts available in the prize pools. The Wisconsin Lottery has the right to a refund of the Wisconsin PRA and SPRA balances if it withdraws from MUSL. The Powerball grand prize deposit is made up of the following:

	<u>June 30, 2003</u>	<u>June 30, 2002</u>
Prize Reserve Account (PRA)	\$6,204,154	\$5,514,054
Balance of Unreserved Account	449,122	1,843,494
Set Prize Reserve Account (SPRA)	<u>1,257,628</u>	<u>1,947,728</u>
Total Powerball Grand Prize Deposit	<u>\$7,910,904</u>	<u>\$9,305,276</u>

Because the PRA and SPRA are refundable upon withdrawal from MUSL, it is the practice of the Wisconsin Lottery to report the prize reserve balances as a receivable (Grand Prize Deposit) and to reduce the prize expense by the same amount when the reserves are increased. The Wisconsin Lottery increases the grand prize deposit and reports interest revenue in the period when the interest in the unreserved account is increased by MUSL.

**B. Cash 4 Life**

The Cash 4 Life game ended on September 7, 2000. During FY 2001-02, approximately one year after the end of the Cash 4 Life game, MUSL returned the Cash 4 Life prize reserve, \$1,206,825, to the Wisconsin Lottery. This amount was removed from the combined Powerball and Cash 4 Life grand prize deposit.

**9. CAPITAL ASSETS**

Capital asset activity for the fiscal year ended June 30, 2003, was as follows:

	<u>Beginning Balance</u>	<u>Increases</u>	<u>Decreases</u>	<u>Ending Balance</u>
Leasehold Improvements	\$ 168,077	\$ 6,025	\$ 0	\$ 174,102
Equipment	<u>1,287,812</u>	<u>0</u>	<u>(169,681)</u>	<u>1,118,131</u>
Total Capital Assets	<u>1,455,889</u>	<u>6,025</u>	<u>(169,681)</u>	<u>1,292,233</u>
Less Accumulated Depreciation for:				
Leasehold Improvements	42,877	12,665	0	55,542
Equipment	<u>1,176,749</u>	<u>51,023</u>	<u>(168,843)</u>	<u>1,058,929</u>
Total Accumulated Depreciation	<u>1,219,626</u>	<u>63,688</u>	<u>(168,843)</u>	<u>1,114,471</u>
Total Capital Assets, Net	<u>\$ 236,263</u>	<u>\$(57,663)</u>	<u>\$ (838)</u>	<u>\$ 177,762</u>

Capital asset activity for the fiscal year ended June 30, 2002, was as follows:

	<u>Beginning Balance</u>	<u>Increases</u>	<u>Decreases</u>	<u>Ending Balance</u>
Leasehold Improvements	\$ 168,077	\$ 0	\$ 0	\$ 168,077
Equipment	<u>1,639,056</u>	<u>20,078</u>	<u>(371,322)</u>	<u>1,287,812</u>
Total Capital Assets	<u>1,807,133</u>	<u>20,078</u>	<u>(371,322)</u>	<u>1,455,889</u>
Less Accumulated Depreciation for:				
Leasehold Improvements	30,533	12,344	0	42,877
Equipment	<u>1,444,481</u>	<u>102,228</u>	<u>(369,960)</u>	<u>1,176,749</u>
Total Accumulated Depreciation	<u>1,475,014</u>	<u>114,572</u>	<u>(369,960)</u>	<u>1,219,626</u>
Total Capital Assets, Net	<u>\$ 332,119</u>	<u>\$(94,494)</u>	<u>\$ (1,362)</u>	<u>\$ 236,263</u>

**10. OPERATING LEASES**

The Wisconsin Lottery occupied office, warehouse, and storage facilities in Milwaukee and on the Beltline Highway in Madison under operating leases during FY 2002-03. The lease for the Milwaukee facility expires June 30, 2004. The Madison Beltline facility lease expires March 31, 2006.

The following schedule summarizes the future minimum lease payments required under operating leases for the Milwaukee and Madison facilities. Upon renewal at the beginning of FY 1999-2000, the Milwaukee warehouse lease payments are scheduled to increase annually based on a formula using the Consumer Price Index (CPI) each March. Since the future CPI is not known, the rate of actual increase between FY 2002-03 and FY 2003-04 lease payment amounts was used to estimate subsequent years' increases. The lease rate for the Madison Beltline Highway facility has been fixed for the remainder of the lease period.

	<u>June 30, 2003</u>	<u>June 30, 2002</u>
Fiscal Year Ending June 30, 2003	—	\$416,653
2004	\$439,723	421,383
2005	39,526	28,884
2006	29,644	21,663
2007	<u>0</u>	<u>0</u>
Total Minimum Payments Required	<u>\$508,893</u>	<u>\$888,583</u>

Total lease expenses for the Wisconsin Lottery amounted to \$418,763 for the fiscal year ended June 30, 2003, and \$411,991 for the fiscal year ended June 30, 2002.

## 11. RESTRICTED NET ASSETS

The Wisconsin Lottery has restricted net assets for fair value adjustments of investments of \$25,346,610 as of June 30, 2003, and \$15,800,334 as of June 30, 2002. The Wisconsin Lottery does not realize gains or losses from the change in fair value of its annuity investments because it holds the investments until maturity to pay the annual prize payments. Therefore, fair value adjustments recognized as investment income as a result of applying GASB Statement 31 are not available for distribution as property tax credits.

The portion of restricted net assets related to capital assets is reported in detail in Note 9.

The Wisconsin Constitution requires net proceeds from the operations of the Wisconsin Lottery to be used to provide local property tax relief. In addition, balances from other gaming-related appropriations, including racing and charitable bingo operations, lapse to the Lottery Fund for distribution in the form of property tax relief. This balance makes up the remainder of the restricted net assets.

**12. DISTRIBUTION OF NET PROCEEDS**

Wisconsin Lottery proceeds and other gaming-related proceeds were used for the following purposes:

	<u>FY 2002-03</u>	<u>FY 2001-02</u>
Lottery Tax Credit	\$106,048,125	\$105,248,760
Farmland Tax Credit	<u>23,516,869</u>	<u>13,744,632</u>
Total Credits	<u>\$129,564,994</u>	<u>\$118,993,392</u>

**13. EMPLOYEE RETIREMENT PLAN**

Permanent, full-time employees of the Wisconsin Lottery are participants in the Wisconsin Retirement System, a cost-sharing, multiple-employer, defined benefit plan governed by Chapter 40 of Wisconsin Statutes. State and local government public employees are entitled to an annual formula retirement benefit based on: 1) the employee's final average earnings, 2) years of creditable service, and 3) a formula factor. If an employee's contributions, matching employer's contributions, and interest credited to the employee's account exceed the value of the formula benefit, the retirement benefit may instead be calculated as a money purchase benefit. The Wisconsin Retirement System is considered part of the State of Wisconsin's financial reporting entity. Copies of the separately issued financial report that includes financial statements and required supplementary information may be obtained by writing to:

Department of Employee Trust Funds  
P.O. Box 7931  
Madison, WI 53707-7931

The report is also available on the Department of Employee Trust Funds' Web site, <http://etf.wi.gov>.

Generally, the State's policy is to fund retirement contributions on a level-percentage-of-payroll basis to meet normal and prior service costs of the retirement system. Prior service costs are amortized over 40 years, beginning January 2, 1990. However, in December 2003 the State issued bonds and subsequently fully liquidated its prior service liability balance as of January 2003. The liquidation of the State's prior service liability resulted in credits being granted to state agencies for amounts already paid in 2003. In addition, state agencies will be required to make future contributions to fund the bond payments.

The retirement plan requires employee contributions equal to specified percentages of qualified earnings based on the employee's classification, plus employer contributions at a rate determined annually. The Wisconsin Lottery's contributions to the plan were \$418,916 for FY 2002-03 and \$405,173

for FY 2001-02. The relative position of the Wisconsin Lottery in the Wisconsin Retirement System is not available because the Wisconsin Retirement System is a statewide, multi-employer plan.

#### 14. COMPENSATED ABSENCES

Compensated absence activity for the fiscal years ended June 30, 2003, and June 30, 2002 was as follows:

<u>Fiscal Year</u>	<u>Beginning Balance</u>	<u>Increases</u>	<u>Decreases</u>	<u>Ending Balance</u>	<u>Due within One Year</u>
2002-03	\$214,901	\$177,145	\$(120,788)	\$271,258	\$127,016
2001-02	183,471	143,859	(112,429)	214,901	120,878

#### 15. EFFECT OF WISCONSIN LAW CHANGES ON LOTTERY PRIZE PAYMENTS

Before the passage of 1999 Wisconsin Act 9, players of Wisconsin's Very Own Megabucks and Powerball selected the lump-sum or annuity payment option at the time a ticket was purchased. Upon enactment of 1999 Wisconsin Act 9, on October 27, 1999, pre-selection of the payment option at the time a ticket is purchased was no longer necessary. Subject to certain restrictions, Wisconsin Lottery prizewinners are currently allowed a 60-day period after becoming entitled to a lottery prize to elect either the lump-sum or the annuity payment option.

1999 Wisconsin Act 9 further provided that lottery prizewinners who became entitled to receive payment of a lottery prize on or before October 21, 1998, and who currently received payment of the lottery prize in the form of an annuity, had the option to elect to change the form of payment to a lump sum if the lottery prize was payable over at least ten years. Persons making this election needed do so between July 1, 1999, and December 31, 2000.

Twelve past annuity prizewinners elected to receive the balance of their prize payments as lump-sum payments during FY 2000-01. One additional past annuity prizewinner's election, which was received by December 31, 2000, was processed in FY 2001-02. As a result, the balances of both the investment for prize annuities and the annuity prizes payable accounts decreased by \$3,823,484 in FY 2001-02. The Wisconsin Lottery did not experience gains or losses on these transactions, since each winner received current market value at the time of the conversion.

#### 16. CHANGE IN ACCOUNTING PRINCIPLE

The Wisconsin Lottery implemented a new financial reporting model for FY 2001-02, as required by the provisions of GASB Statement Number 34, *Basic Financial Statements—and Management's Discussion and Analysis—for State*



*and Local Governments.* Financial statement presentation changed to reflect net assets invested in capital assets, net of related debt; net assets restricted for investment fair market value adjustment; and net assets restricted for property tax relief. In addition, management added a discussion and analysis of operations.

In FY 2002-03, the Wisconsin Lottery implemented GASB Statement Number 38, *Certain Financial Statement Note Disclosures*, which necessitated the inclusion of an additional note, which is included as Note 5.

## 17. TRANSFERS TO THE GENERAL FUND

- A. 2001 Wisconsin Act 109, Section 9159 created a sick leave conversion credit of \$99,155 that was transferred to the General Fund in FY 2002-03.
- B. 1999 Wisconsin Act 11 created a retirement credit of \$78,844 that was transferred to the General Fund in FY 2001-02, subject to the provisions of 2001 Wisconsin Act 16. This transfer is explained in detail in Note 18.

## 18. RESTATEMENT OF FY 2001-02 FINANCIAL STATEMENTS

- A. Instant prize expense and prizes payable were reduced by \$457,394 to correct an error in the calculation of FY 2001-02 instant prize expense. The effect of this adjustment is to increase net assets reported at June 30, 2002, by \$457,394.
- B. 1999 Wisconsin Act 11 created a retirement credit of \$78,844 that was transferred to the General Fund in FY 2001-02, subject to the provisions of 2001 Wisconsin Act 16. This amount was previously recorded as salaries and fringe benefits expense of \$73,212, transfers to the Department of Justice for law enforcement of \$3,786, and transfers to the Department of Revenue for lottery credit administration of \$1,846. There is no effect on ending net assets.
- C. An adjustment was made to correct fixed assets and beginning net assets for the disposition of a previously unrecorded and undepreciated asset valued at \$794. This adjustment resulted in a decrease in the net assets reported at June 30, 2002, by the same amount.
- D. A \$300 correction was made to cash and beginning net assets for an error existing since FY 1995-96. This adjustment resulted in a corresponding increase in net assets at June 30, 2002.

■ ■ ■ ■



---

## **Supplementary Information ■**

---

## Reconciliation of Lottery General Operations Expenses to the Budgetary Basis of Accounting—FY 2002-03

### SALARIES AND FRINGE BENEFITS

Per Financial Statement	\$ 5,399,940
Adjustments to Financial Statement Balance:	
Cash paid in FY 2002-03 but expensed in FY 2001-02	214,901
Cash paid in FY 2003-04 but expensed in FY 2002-03	(200,662)
<b>Budgetary Basis—Salaries and Fringe Benefits</b>	<b>\$ 5,414,179</b>

### SUPPLIES AND SERVICES

Per Financial Statement:	
On-line telecommunications charges	\$ 3,093,877
Product information costs	4,579,937
Instant ticket printing costs	3,117,049
Supplies and services	4,181,717
Instant ticket delivery costs	554,808
Depreciation expense	63,688
Total Per Financial Statement	15,591,076
Adjustments to Financial Statement Balance:	
Depreciation expense	(63,688)
Cash paid in FY 2001-02 but expensed in FY 2002-03	(849,623)
Cash paid in FY 2002-03 but expensed in FY 2001-02	63,408
Cash paid in FY 2002-03 but expensed in FY 2003-04	1,040,322
Cash paid in FY 2003-04 but expensed in FY 2002-03	(28,627)
Supplies purchased with the vendor fees appropriation	(44,131)
<b>Budgetary Basis—Supplies and Services</b>	<b>\$ 15,708,737</b>

### CAPITAL ASSETS

Per Financial Statement	\$ 0
Adjustments to Financial Statement Balance:	
FY 2002-03 permanent property capitalized	(164,450)
FY 2002-03 disposal of permanent property	170,475
<b>Budgetary Basis—Capital Assets</b>	<b>\$ 6,025</b>

# **Statutorily Defined Lottery Administrative Expenses for the Years Ended June 30, 2001 through 2003**

	Fiscal Year Ended <u>June 30, 2003</u>	Fiscal Year Ended <u>June 30, 2002</u>	Fiscal Year Ended <u>June 30, 2001</u>
<b>ADMINISTRATIVE EXPENSES</b>			
Instant and On-Line Vendor Services	\$ 12,464,364	\$ 12,344,833	\$ 12,116,681
Salaries and Fringe Benefits	5,399,940	5,038,051	4,944,999
On-Line Telecommunications Charges	3,093,877	3,090,190	3,094,601
Supplies and Services	4,181,717	4,296,796	5,248,934
Product Information Costs	4,579,937	4,520,065	4,607,042
Instant Ticket Printing Costs	3,117,049	3,625,080	2,893,774
Instant Ticket Delivery Costs	554,808	545,253	482,162
Depreciation Expense	<u>63,688</u>	<u>114,573</u>	<u>191,189</u>
Total Administrative Expenses as Determined in Accordance with s. 25.75(3)(b), Wis. Stats.	<u>\$ 33,455,380</u>	<u>\$ 33,574,841</u>	<u>\$ 33,579,382</u>
Gross Lottery Operating Revenues	<u>\$ 435,119,501</u>	<u>\$ 427,666,243</u>	<u>\$ 403,725,942</u>
<b>Administrative Expenses as a Percentage of Lottery Revenues</b>	<b>7.69%</b>	<b>7.85%</b>	<b>8.32%</b>

Section 25.75(3)(b), Wis. Stats., limits the Lottery's administrative expenses to 10 percent of gross lottery revenues. Gross lottery revenues include lottery ticket sales and retailer fees. Retailer commissions are not included as an administrative expense in the calculation.

## Summary of Prize Expenses for the Years Ended June 30, 1999 through 2003

Section 25.75(3)(a), Wis. Stats., requires that at least 50 percent of each year's revenues from the sale of lottery tickets be returned as prizes to the holders of winning lottery tickets. The amounts expended for winning lottery tickets for the past five years, for both instant and on-line games, are summarized below.

<b>Fiscal Year 2002-03</b>			
	<u>Prize Expense</u>	<u>Ticket Sales</u>	<u>Prize Expense as a Percentage of Sales</u>
Instant Games	\$ 158,065,880	\$ 249,467,428	63.4%
On-Line Games	<u>90,443,737</u>	<u>185,570,386</u>	48.7
Total for Fiscal Year	\$ 248,509,617	\$ 435,037,814	57.1

<b>Fiscal Year 2001-02</b>			
	<u>Prize Expense</u>	<u>Ticket Sales</u>	<u>Prize Expense as a Percentage of Sales</u>
Instant Games	\$ 150,658,770	\$ 238,214,016	63.2%
On-Line Games	<u>90,940,299</u>	<u>189,336,327</u>	48.0
Total for Fiscal Year	\$ 241,599,069	\$ 427,550,343	56.5

<b>Fiscal Year 2000-01</b>			
	<u>Prize Expense</u>	<u>Ticket Sales</u>	<u>Prize Expense as a Percentage of Sales</u>
Instant Games	\$ 149,827,633	\$ 237,944,206	63.0%
On-Line Games	<u>83,071,579</u>	<u>163,244,349</u>	50.9
Total for Fiscal Year	\$ 232,899,212	\$ 401,188,555	58.1

<b>Fiscal Year 1999-2000</b>			
	<u>Prize Expense</u>	<u>Ticket Sales</u>	<u>Prize Expense as a Percentage of Sales</u>
Instant Games	\$ 152,238,914	\$ 241,040,895	63.2%
On-Line Games	<u>80,983,868</u>	<u>165,629,273</u>	48.9
Total for Fiscal Year	\$ 233,222,782	\$ 406,670,168	57.3

<b>Fiscal Year 1998-99</b>			
	<u>Prize Expense</u>	<u>Ticket Sales</u>	<u>Prize Expense as a Percentage of Sales</u>
Instant Games	\$ 143,841,064	\$ 230,817,635	62.3%
On-Line Games	<u>92,860,756</u>	<u>197,378,447</u>	47.0
Total for Fiscal Year	\$ 236,701,820	\$ 428,196,082	55.3

NOTE: The above amounts are based on an accrual basis of accounting, with adjustments made to prize expense for unclaimed winning tickets and reserve accounts. For each game, the prize structure represents the number, value, and odds of winning for each prize and is used to estimate the expected amounts to be paid to lottery winners. The games' actual prizes (prize expense) may be less than the games' structure because of unclaimed winning tickets and deposits in reserve accounts.

---

# Report on Compliance and Control ■

---

## ***Independent Auditor's Report on Compliance and on Internal Control over Financial Reporting Based on an Audit of Financial Statements Performed in Accordance with Government Auditing Standards***

We have audited the financial statements of the Wisconsin Lottery as of and for the years ended June 30, 2003 and 2002, and have issued our report thereon dated May 21, 2004. We conducted our audits in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States.

### **COMPLIANCE**

As part of obtaining reasonable assurance about whether the Wisconsin Lottery's financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, and contracts, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit and, accordingly, we do not express such an opinion. The results of our tests disclosed no instances of noncompliance that are required to be reported under *Government Auditing Standards*. However, we noted certain immaterial instances of noncompliance that have been reported in separate correspondence.

## INTERNAL CONTROL OVER FINANCIAL REPORTING

In planning and performing our audits, we considered the Wisconsin Lottery's internal control over financial reporting in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements and not to provide assurance on the internal control over financial reporting. Our consideration of the internal control over financial reporting would not necessarily disclose all matters in the internal control over financial reporting that might be material weaknesses. A material weakness is a condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. We noted no matters involving the internal control over financial reporting and its operation that we consider to be material weaknesses.

This independent auditor's report is intended for the information and use of Wisconsin Lottery staff, the Department of Revenue's management, and the Wisconsin Legislature. This independent auditor's report, upon submission to the Joint Legislative Audit Committee, is a matter of public record and its distribution is not limited. However, because we do not express an opinion on compliance or provide assurance on internal control over financial reporting, this report is not intended to be used by anyone other than these specified parties.

LEGISLATIVE AUDIT BUREAU

May 21, 2004

by   
Julie Gordon  
Audit Director